

assets means the sum of the money, plus the aggregate of the adjusted basis of the property other than money held by the taxpayer in good faith for the purpose of the business. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes.

(3) If the percentage computation required by subparagraph (2) of this paragraph results in a figure in excess of 15 percent for the taxable year, there is interest that does not come within the special rule for certain financial institutions contained in section 265(2). The amount of such interest is obtained by multiplying the total interest paid or accrued for the taxable year on face-amount certificates and on amounts received for the purchase of such certificates by the percentage figure equal to the excess of the percentage figure computed under subparagraph (2) of this paragraph over 15 percent. See paragraph (a) for the disallowance of interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax under Subtitle A of the Code.

(4) Every financial institution claiming the benefits of the special rule for certain financial institutions contained in section 265(2) shall file with its return for the taxable year:

(i) A statement showing that it is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 and following) and that it is subject to the banking laws of the State in which it is incorporated.

(ii) A detailed schedule showing the computation of the average amount of tax-exempt obligations, the average amount of total assets of such institutions, and the total amount of interest paid or accrued on face-amount certificates and on amounts received for the purchase of such certificates for the taxable year.

[T.D. 6927, 32 FR 13221, Sept. 19, 1967]

§ 1.265-3 Nondeductibility of interest relating to exempt-interest dividends.

(a) *In general.* No deduction is allowed to a shareholder of a regulated

investment company for interest on indebtedness that relates to exempt-interest dividends distributed by the company to the shareholder during the shareholder's taxable year.

(b) *Interest relating to exempt-interest dividends.* (1) All or a portion of the interest on an indebtedness relates to exempt-interest dividends if the indebtedness is either incurred or continued to purchase or carry shares of stock of a regulated investment company that distributes exempt-interest dividends (as defined in section 852(b)(5) of the Code) to the holder of the shares during the shareholder's taxable year.

(2) To determine the amount of interest that relates to the exempt-interest dividends the total amount of interest paid or accrued on the indebtedness is multiplied by a fraction. The numerator of the fraction is the amount of exempt-interest dividends received by the shareholder. The denominator of the fraction is the sum of the exempt-interest dividends and taxable dividends received by the shareholder (excluding capital gain dividends received by the shareholder and capital gains required to be included in the shareholder's computation of long-term capital gains under section 852(b)(3)(D)).

[T.D. 7601, 44 FR 16013, Mar. 16, 1979]

§ 1.266-1 Taxes and carrying charges chargeable to capital account and treated as capital items.

(a)(1) *In general.* In accordance with section 266, items enumerated in paragraph (b)(1) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property of the type described in this section are chargeable to capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of Subtitle A of the Code. No deduction is allowable for any items so treated.

(2) See §§ 1.263A-8 through 1.263A-15 for rules regarding the requirement to capitalize interest, that apply prior to the application of this section. After applying §§ 1.263A-8 through 1.263A-15, a taxpayer may elect to capitalize interest under section 266 with respect to

designated property within the meaning of § 1.263A-8(b), provided a computation under any provision of the Internal Revenue Code is not thereby materially distorted, including computations relating to the source of deductions.

(b) *Taxes and carrying charges.* (1) The taxpayer may elect, as provided in paragraph (c) of this section, to treat the items enumerated in this subparagraph which are otherwise expressly deductible under the provisions of Subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1). The items thus chargeable to capital account are:

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.

(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive:

(a) Interest on a loan (but not theoretical interest of a taxpayer using his own funds),

(b) Taxes of the owner of such real property measured by compensation paid to his employees,

(c) Taxes of such owner imposed on the purchase of materials, or on the storage, use, or other consumption of materials, and

(d) Other necessary expenditures, paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed. The development or construction work with respect to which such items are incurred may relate to unimproved and unproductive real estate whether the construction work will make the property productive of income subject to tax (as in the case of a factory) or not (as in the case of a personal residence), or may relate to property already improved or productive (as in the case of a plant addition or improvement, such as the construction of another floor on a factory or the installation of insulation therein).

(iii) In the case of personal property:

(a) Taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein,

(b) Interest on a loan to purchase such property or to pay for transporting or installing the same, and

(c) Taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property,

paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

(iv) Any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.

(2) The sole effect of section 266 is to permit the items enumerated in subparagraph (1) of this paragraph to be chargeable to capital account notwithstanding that such items are otherwise expressly deductible under the provisions of Subtitle A of the Code. An item not otherwise deductible may not be capitalized under section 266.

(3) In the absence of a provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of this section, and items which are otherwise treated as capital items are to be so treated. Similarly, an item not otherwise deductible is not made deductible by this section. Nor is the absence of a provision in this section for treating a given item as a capital item to be construed as withdrawing or modifying the right now given to the taxpayer under any other provisions of subtitle A of the Code, or of the regulations thereunder, to elect to capitalize or to deduct a given item.

(c) *Election to charge taxes and carrying charges to capital account.* (1) If for any taxable year there are two or more items of the type described in paragraph (b)(1) of this section, which relate to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or

more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if expenditures for several items of the same type are incurred with respect to a single project, the election to capitalize must, if exercised, be exercised as to all items of that type. For purposes of this section, a *project* means, in the case of items described in paragraph (b)(1)(ii) of this section, a particular development of, or construction of an improvement to, real property, and in the case of items described in paragraph (b)(1)(iii) of this section, the transportation and installation of machinery or other fixed assets.

(2)(i) An election with respect to an item described in paragraph (b)(1)(i) of this section is effective only for the year for which it is made.

(ii) An election with respect to an item described in:

(a) Paragraph (b)(1)(ii) of this section is effective until the development or construction work described in that subdivision has been completed;

(b) Paragraph (b)(1)(iii) of this section is effective until the later of either the date of installation of the property described in that subdivision, or the date when such property is first put into use by the taxpayer;

(c) Paragraph (b)(1)(iv) of this section is effective as determined by the Commissioner.

Thus, an item chargeable to capital account under this section must continue to be capitalized for the entire period described in this subdivision applicable to such election although such period may consist of more than one taxable year.

(3) If the taxpayer elects to capitalize an item or items under this section, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items (whether with respect to the same project or to different projects) which the taxpayer elects to treat as chargeable to capital account. Elections filed for taxable years beginning before January 1, 1954, and for taxable years ending before August 17, 1954, under section 24(a)(7) of the Internal Revenue

Code of 1939, and the regulations thereunder, shall have the same effect as if they were filed under this section. See section 7807(b)(2).

(d) The following examples are illustrative of the application of the provisions of this section:

Example 1. In 1956 and 1957 A pays annual taxes and interest on a mortgage on a piece of real property. During 1956, the property is vacant and unproductive, but throughout 1957 A operates the property as a parking lot. A may capitalize the taxes and mortgage interest paid in 1956, but not the taxes and mortgage interest paid in 1957.

Example 2. In February 1957, B began the erection of an office building for himself. B in 1957, in connection with the erection of the building, paid \$6,000 social security taxes, which in his 1957 return he elected to capitalize. B must continue to capitalize the social security taxes paid in connection with the erection of the building until its completion.

Example 3. Assume the same facts as in *Example 2* except that in November 1957, B also begins to build a hotel. In 1957 B pays \$3,000 social security taxes in connection with the erection of the hotel. B's election to capitalize the social security taxes paid in erecting the office building started in February 1957 does not bind him to capitalize the social security taxes paid in erecting the hotel; he may deduct the \$3,000 social security taxes paid in erecting the hotel.

Example 4. In 1957, M Corporation began the erection of a building for itself, which will take three years to complete. M Corporation in 1957 paid \$4,000 social security taxes and \$3,000 interest on a building loan in connection with this building. M Corporation may elect to capitalize the social security taxes although it deducts the interest charges.

Example 5. C purchases machinery in 1957 for use in his factory. He pays social security taxes on the labor for transportation and installation of the machinery, as well as interest on a loan to obtain funds to pay for the machinery and for transportation and installation costs. C may capitalize either the social security taxes or the interest, or both, up to the date of installation or until the machinery is first put into use by him, whichever date is later.

(e) *Allocation.* If any tax or carrying charge with respect to property is in part a type of item described in paragraph (b) of this section and in part a type of item or items with respect to which no election to treat as a capital item is given, a reasonable proportion of such tax or carrying charge, determined in the light of all the facts and

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circumstances in each case, shall be allocated to each item. The rule of this paragraph may be illustrated by the following example:

Example. N Corporation, the owner of a factory in New York on which a new addition is under construction, in 1957 pays its general manager, B, a salary of \$10,000 and also pays a New York State unemployment insurance tax of \$81 on B's salary. B spends nine-tenths of his time in the general business of the firm and the remaining one-tenth in supervising the construction work. N Corporation treats as expenses \$9,000 of B's salary, and charges the remaining \$1,000 to capital account. N Corporation may elect to capitalize \$8.10 of the \$81 New York State unemployment insurance tax paid in 1957 since such tax is deductible under section 164.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8584, 59 FR 67215, Dec. 29, 1994]

§ 1.267(a)-1 Deductions disallowed.

(a) *Losses.* Except in cases of distributions in corporate liquidations, no deduction shall be allowed for losses arising from direct or indirect sales or exchanges of property between persons who, on the date of the sale or exchange, are within any one of the relationships specified in section 267(b). See § 1.267(b)-1.

(b) *Unpaid expenses and interest.* (1) No deduction shall be allowed a taxpayer for trade or business expenses otherwise deductible under section 162, for expenses for production of income otherwise deductible under section 212, or for interest otherwise deductible under section 163:

(i) If, at the close of the taxpayer's taxable year within which such items are accrued by the taxpayer or at any time within 2 1/2 months thereafter, both the taxpayer and the payee are persons within any one of the relationships specified in section 267(b) (see § 1.267(b)-1); and

(ii) If the payee is on the cash receipts and disbursements method of accounting with respect to such items of gross income for his taxable year in which or with which the taxable year of accrual by the debtor-taxpayer ends; and

(iii) If, within the taxpayer's taxable year within which such items are accrued by the taxpayer and 2 1/2 months after the close thereof, the amount of

such items is not paid and the amount of such items is not otherwise (under the rules of constructive receipt) includible in the gross income of the payee.

(2) The provisions of section 267(a)(2) and this paragraph do not otherwise affect the general rules governing the allowance of deductions under an accrual method of accounting. For example, if the accrued expenses or interest are paid after the deduction has become disallowed under section 267(a)(2), no deduction would be allowable for the taxable year in which payment is made, since an accrual item is deductible only in the taxable year in which it is properly accruable.

(3) The expenses and interest specified in section 267(a)(2) and this paragraph shall be considered as paid for purposes of that section to the extent of the fair market value on the date of issue of notes or other instruments of similar effect received in payment of such expenses or interest if such notes or other instruments were issued in such payment by the taxpayer within his taxable year or within 2 1/2 months after the close thereof. The fair market value on the date of issue of such notes or other instruments of similar effect is includible in the gross income of the payee for the taxable year in which he receives the notes or other instruments.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. A, an individual, is the holder and owner of an interest-bearing note of the M Corporation, all the stock of which was owned by him on December 31, 1956. A and the M Corporation make their income tax returns for a calendar year. The M Corporation uses an accrual method of accounting. A uses a combination of accounting methods permitted under section 446(c)(4) in which he uses the cash receipts and disbursements method in respect of items of gross income. The M Corporation does not pay any interest on the note to A during the calendar year 1956 or within 2 1/2 months after the close of that year, nor does it credit any interest to A's account in such a manner that it is subject to his unqualified demand and thus is constructively received by him. M Corporation claims a deduction for the year 1956 for the interest accruing on the note in that year. Since A is on the cash receipts and disbursements method in respect of items of